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Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1999

THE CHARLES SCHWAB CORPORATION and INCLUDABLE SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Background

Virtually all business taxpayers must report their income and deductions for federal income tax purposes using an accrual method of accounting. Under applicable income tax regulations, and as enunciated by this Court in, inter alia, United States v. General Dynamics Corp., 481 U.S. 239 (1987), the benchmark standard for accrual accounting is the "all events" test. Under that test items of income and deduction accrue when all events have occurred to fix the right to income (or the liability for an expense) and the amount of the item can be determined with reasonable accuracy.

Question

Under the "all events" test, is a business taxpayer taxable on income from a transaction only when it completes all activities that are required by the contract for the transaction, in conformity with General Dynamics, or may it be subject to tax when it has completed a lesser set of activities that are deemed "essential" to the transaction even though the contract requires the taxpayer to perform additional activities to earn the right to payment of the income?

CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 29.6 of the Supreme Court Rules, Petitioners hereby certify that The Charles Schwab Corporation has no parent corporation and that no publicly held company owns ten percent or more of its stock.

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OPINION AND ORDERS BELOW

The Order of the United States Court of Appeals for the Ninth Circuit is unpublished; a copy of the Order is included as Appendix A. The Opinion of the United States Tax Court is published at 107 T.C. 282 (1996); a copy is included as Appendix B.

JURISDICTION

On December 9, 1998, the Ninth Circuit entered an unpublished Order adopting the reasoning of the United States Tax Court in Charles Schwab Corp. v. Commissioner of Internal Revenue, 107 T.C. 282 (1996), and affirming the Tax Court's decision (the "Order").

On March 17, 1999, the Ninth Circuit entered an order denying Petitioners' petition for rehearing and suggestion for rehearing en banc.

This Court has jurisdiction under 28 U.S.C. § 1254 to review the Order on a writ of certiorari.

APPLICABLE REGULATIONS

This case involves the interpretation and application of 26 C.F.R. ("Treas. Reg.") §§ 1.446-1(c)(1)(ii), 1.451-1(a), and 1.461-1(a)(2), set forth below as they appeared in the taxable years in issue.

As relevant here, Treas. Reg. §1.446-1(c)(1)(ii) provides:

> Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy.

As relevant here, Treas. Reg. §1.451-1(a) provides:

> Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

As relevant here, Treas. Reg. §1.461-1(a)(2) provides:

> Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

STATEMENT OF THE CASE

In this case, Respondent (the "Commissioner") seeks to tax income before the taxpayer has completed the tasks required by its contract with its customer to earn the income. This result is contrary to settled case law, and specifically is contrary to this Court's decision in United States v. General Dynamics Corp., 481 U.S. 239 (1987).

Petitioner Charles Schwab & Co. ("Schwab") is the largest and best-known discount brokerage firm in the nation.

Most of Schwab's income comes from brokerage commissions. Each brokerage transaction involves a "trade" date and a "settlement" date. The "trade" date is the day the customer places an order to buy or sell securities. On the trade date, Schwab "executes" the order by locating a contra-broker who represents a person wanting to be on the other side of the transaction. That is, if the order is a buy order, Schwab in effect matches its customer with a seller. If the order is a sell order, Schwab matches its customer with a buyer. This process is done by computer and requires little time. For example, when an order is placed by telephone during an exchange's business hours, Schwab is generally able to match it with a seller or buyer while Schwab's customer is still on the telephone.

On the "settlement" date, five business days later (during the taxable years in issue), Schwab completes — "settles" — the transaction by physically effecting an exchange of its customer's cash for securities in the case of a purchase or of its customer's securities for cash in the case of a sale.

Schwab's standard customer contract requires the customer to pay Schwab for transactions in the customer's brokerage account. Schwab's bill to the customer requires payment by the settlement date. If Schwab does not settle a transaction, it has no contractual right to payment.

For federal income tax purposes as well as for financial reporting purposes, Schwab adopted an accrual accounting method under which it takes its commissions into income on the "settlement" date — the date on which money and securities are actually exchanged and Schwab is contractually entitled to its commission.

The Commissioner issued a statutory notice of deficiency in federal income tax to Petitioners on December 12, 1991, asserting (as relevant here) that Schwab was obligated to account for its commission income as of the "trade" date of each brokerage transaction — the date on which Schwab receives an order and matches it with a seller or buyer.

Petitioners timely filed a petition for redetermination of tax to the United States Tax Court. The statutory basis of the Tax Court's subject-matter jurisdiction is set forth in 26 U.S.C. ("I.R.C.") § 7442. The Tax Court held in the Commissioner's favor. It characterized Schwab's activities after the trade date, including settlement, as not "essential" but as "ministerial" and as "conditions subsequent" rather than "conditions precedent" to the accrual of Schwab's commission income.

Petitioners timely appealed the Tax Court's decision to the Ninth Circuit Court of Appeals. The Ninth Circuit's

jurisdiction over the appeal is set forth in I.R.C. § 7482(a)(1). The Ninth Circuit adopted the Tax Court's reasoning and decision and denied Petitioners' petition for rehearing en banc. This Petition followed.

REASONS FOR GRANTING THE WRIT

This case of first impression raises a fundamental issue regarding the accrual of income for purposes of the federal income tax. Because it involves a basic principle of accrual accounting, this case potentially affects every business taxpayer in the nation.[1]

This Petition should be granted because the decision of the Tax Court, adopted by the Ninth Circuit: (1) conflicts with the decision of this Court in United States v. General Dynamics Corp., 481 U.S. 239 (1987), and (2) announces an open-ended and poorly reasoned new standard of accrual accounting that, if allowed to stand, can only confuse and burden the nation's taxpayers and courts for decades to come.

The benchmark rule of accrual accounting for federal income tax purposes is the "all events" test: Items of income (or deduction) accrue when "all the events have occurred

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[1] Virtually all business taxpayers are required to use an accrual method of accounting. Treas. Reg. § 1.446-1(c)(2)(i) requires every taxpayer using an inventory to use the accrual method for purchases and sales. I.R.C. § 448 requires regular ("C") corporations with annual gross receipts of at least $5 million to use an accrual method (by forbidding use of the cash method). And I.R.C. § 447(a) requires corporations engaged in most farming activities to use an accrual method.

which fix the right to receive such income [or the liability for the deduction] and the amount thereof can be determined with reasonable accuracy." Treas. Reg. §1.446-1(c)(1)(ii).[2]

The decision of the Ninth Circuit and the Tax Court injects substantial and irremediable uncertainty into the "all events" test by re-defining "event" so that a contractually required act does not count as an "event" unless it is an "essential" part of the services or goods offered by the taxpayer. In this context, however, the term "essential" has no readily ascertainable meaning: What is "essential" to one taxpayer may be merely desirable to another and trivial to a third. The courts below compounded this error by mischaracterizing non-"essential" actions as both "ministerial" in nature and "conditions subsequent" to the accrual of income. In so doing, the lower courts borrowed, and mis-applied, the term "ministerial" from a decision of this Court and confused the meanings of "condition precedent" and "condition subsequent."

Worse, however, from the perspective of the nation's taxpayers and courts, is that neither the Ninth Circuit nor the Tax Court offered any view as to the qualities that cause some contractually required events to be deemed "essential," non-"ministerial," and "conditions precedent" while others are deemed non-"essential," "ministerial," and "conditions subsequent." As a result, all accrual method taxpayers are left to ponder which of their income-producing activities are

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[2] All citations to Treasury Regulations are to the regulations as they appeared in 1988, the taxable year in issue.

in some sense "essential" and constitute "events" in the "all events" test and which are less important and subject to attack by the Commissioner.

The ambiguity and subjectivity of the standard proposed by the Ninth Circuit and the Tax Court are in stark contrast to the clear and hard-edged standard enunciated by this Court in General Dynamics, supra: If an activity is contractually required, then it is an "event" and must occur before the income accrues under the "all events" test. If the decision of the Ninth Circuit and the Tax Court is allowed to stand, it will undermine the standard of General Dynamics. Given that the meaning of "event" lies at the heart of the "all events" test, and that uniformity and predictability are of paramount importance in tax accounting methods, this Petition should be granted.

A. The Lower Courts' Decision Conflicts with this Court's Decision in General Dynamics.

In General Dynamics, supra, the issue was when "all events" had occurred to establish the taxpayer's liability to reimburse its employees for medical care. The taxpayer's reimbursement plan required employees who had received medical care to submit claim forms in order to be reimbursed. This Court held that "all events" had occurred only when the taxpayer received the claim forms:

> General Dynamics was thus liable to pay for covered medical services *only* if properly documented claims forms were filed. [General Dynamics, supra, 481 U.S. at 244; emphasis in original.]

The possibility that employees would fail to file claims for reimbursement after having received and paid for medical care was acknowledged to be an "extremely remote and speculative possibility." Id., at 244 (citation omitted).[3] This Court nonetheless held that under the "all events" test, the taxpayer's reimbursement obligation did not accrue until a claim form was filed. This Court found that since submission of the claim form was the "last link in the chain of events creating liability for purposes of the 'all events' test," id., the possibility of non-submission was not "the type" of "remote and speculative" contingency that would cause the submission of a claim to be disregarded as a required "event." In other words, because the filing of a claim was a legal precondition to the taxpayer's liability, it intrinsically constituted an "event" under the "all events" test:

> Such filing is not a mere technicality. It is crucial to the establishment of liability on the part of the taxpayer. [Id.]
>
> * * *
>
> We conclude that, as a matter of law, the filing of a claim was necessary to create liability. [Id., at n.4.]

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[3] Indeed, the dissent characterized the prospect of non-filing of claims as "at most a 'merely formal contingenc[y], or [one] highly improbable under the known facts.'" Id., at 250 (O'Connor, Blackmun, Stevens, JJ., dissenting; citations omitted).

The instant case is indistinguishable from General Dynamics. Here, as in General Dynamics, the taxpayer is subject to contractual terms that are not satisfied until a highly probable final act is performed. In General Dynamics, the final act that gave rise to liability was submission of the claim form. Here, the final act that establishes Schwab's contractual right to its commission income is Schwab's settlement of the transaction. It follows that, under the standard established by this Court in General Dynamics, settlement was "crucial to the establishment" of Schwab's right to its commission.[4]

Under Schwab's contractual arrangements with its customers, a customer is not obligated to pay Schwab its commission until Schwab has settled the particular transaction for the customer by physically effecting an exchange of the customer's securities for cash (if the transaction is a sale) or of the customer's cash for securities (if the transaction is a purchase). Under the standards established by this Court in General Dynamics, Schwab is therefore not obligated to accrue its commission as taxable

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[4] Although General Dynamics concerned accrual of deductions, the language of the "all events" test is the same for both the accrual of income and the accrual of deductions. Compare Treas. Reg. §§ 1.451-1(a) (income) and 1.461-1(a)(2) (deductions). Moreover, General Dynamics has been applied by two Circuit Courts of Appeals and the Tax Court to the accrual of income. Resale Mobile Homes, Inc. v. Commissioner, 965 F.2d 818, 823 (10th Cir. 1992); Lamm v. Commissioner, 873 F.2d 194, 196 (8th Cir. 1989); Beauty Acquisition Corp. v. Commissioner, 69 T.C.M. (CCH) 1971, 1977, T.C. Memo. 1995-87 (1995).

income until the settlement date, when it achieves the right to payment, because only then is Schwab's contractual right to the commission "firmly established." Id., at 243.

The Ninth Circuit/Tax Court decision nonetheless held that Schwab's settlement-date activities were to be disregarded under the "all events" test, based on an erroneous characterization of those services as non-"essential" and "ministerial":

> [Schwab] argues that its commission is earned when delivery of the securities and payment of the purchase price occur, which is not until the settlement date ... [The Commissioner], on the other hand, argues that execution of an order on behalf of a customer is the essential service that [Schwab] performs and is the time at which [Schwab's] right to receive, and the customer's obligation to pay, the commission arises. According to [the Commissioner], all the actions that remain to be performed by [Schwab] after the trade date are of a ministerial nature to effectuate the mechanics of the transfer and are merely in confirmation of the trade executed. We agree with [the Commissioner].
>
> [Schwab] is a member of all major U.S. securities exchanges. The essential service that [Schwab] provides to its customers is the execution of trades through its access to the securities exchanges. It is through this access that the customer acquires the ability to make

a trade. [Schwab, supra, 107 T.C. at 292, App. B, infra, at 17-a.]

In this holding, the Ninth Circuit and the Tax Court committed at least three errors. First, in applying the "all events" test without treating Schwab's contractual duty to complete transactions on the settlement date as an "event," the lower courts ignored this Court's holding in General Dynamics.

Second, the lower courts enunciated no standards for determining what elements cause an activity to be "essential" as opposed to "ministerial," but simply interjected their own judgment as to what feature of Schwab's activities on behalf of its customers they believed to be "essential" to those customers.[5]

Third, the judgment the lower courts made is contradicted not only by Schwab's contract with its customers, but also by plain common sense. Schwab's business is effecting purchases and sales on behalf of its customers. The "essence" of a sale, from a customer's perspective, is the receipt in hand of the net cash proceeds. For a purchaser, it is the delivery of the securities purchased. The mechanics of effecting the transaction — including

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[5] As discussed in greater detail below, this impetus to interject subjective judgment was not a fluke — the "essential" vs. "ministerial" acts standard adopted by the lower courts inherently constitutes an open, seductive, and treacherous invitation to the Commissioner and the courts to make their own determinations as to which elements of each taxpayer's business are "essential" and which are "ministerial."

execution of the trade on the trade date — are the details. The crucial goal is getting the cash or securities the customer has contracted for.

B. The Lower Courts Misapplied this Court's Decision in Continental Tie & Lumber Co.

The Tax Court and the Ninth Circuit took the term "ministerial" from this Court's decision in Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932), and gave it a meaning not intended by this Court.

In Continental Tie, the issue was whether the taxpayer's accrual of income should be delayed after "all events" had occurred to fix the right to income, by the act of computing the exact amount of the income. This Court held that the income accrued when the right to it became fixed and used the term "ministerial," id., at 295, to describe the subsequent administrative procedure of ascertaining, after all events had occurred, the amount of income that had been earned.

In the instant case, the Ninth Circuit/Tax Court decision cited Continental Tie for the proposition that ministerial acts do not affect the time that income accrues,[6] but then misapplied the term to acts that occur before the

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[6] The Ninth Circuit/Tax Court decision cited two additional cases for this proposition, Dally v. Commissioner, 227 F.2d 724, 726 (9th Cir. 1955), which correctly states that the "ministerial act" referred to in Continental Tie was that of computation after the right to income had accrued, and Resale Mobile Homes, supra, also a computation case.

right to the income has been earned. 107 T.C. at 292-94, App. B at 16-a.

The Ninth Circuit and Tax Court compounded this error by then trying to re-explain the difference between "essential" and "ministerial" events in terms of "conditions precedent" and "conditions subsequent:"

> In applying the all events test, this and other courts have distinguished between conditions precedent, which must occur before the right to income arises, and conditions subsequent, the occurrence of which will terminate an existing right to income, but the presence of which does not preclude accrual of income. [Citations omitted.]
>
> We think the above factors indicate that [Schwab's] execution of a trade for a customer is a condition precedent that fixes [Schwab's] right to receive the commission income. The functions that remain to be performed by [Schwab] after the trade date are of a ministerial nature to effectuate the mechanics of the transfer and confirm the trade executed. Although failure to perform these functions may ultimately divest [Schwab] of its right to the commission income, we think that these functions are conditions subsequent and, therefore, do not preclude accrual of commission income on the trade date. [Schwab, supra, 107 T.C. at 293-94, App. B at 18-a, 19-a]

When the courts have defined "condition precedent" and "condition subsequent" for purposes of income accrual, they have in effect said that "conditions precedent" are the events that need to occur so that continuation of the status quo thereafter will result in the receipt of the income. A condition subsequent is an event the later occurrence of which would be inconsistent with the right to receive the income.[7] See, e.g., Wien Consol. Airlines, Inc. v. Commissioner, 60 T.C. 13, 15 (1973), aff'd, 528 F.2d 735, 737 n.4 (9th Cir. 1976); Buckeye International, Inc. v. Commissioner, 49 T.C.M. (CCH) 376, 382, T.C.Memo. 1984-668.

In the instant case, however, the Ninth Circuit and the Tax Court have confused the concepts. Continuation of the status quo at the time of the trade date would not result in receipt by Schwab of its commission, for the basic reason that exchange of the securities for the cash would not yet

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[7] Commentators agree: It is textbook law that the term "condition precedent" denotes an act or event, other than the lapse of time, that must exist or occur before the other contracting party's performance under the contract becomes due. Calamari & Perillo, Contracts, 439 (3rd Ed. 1987); RESTATEMENT (SECOND) CONTRACTS § 225 (1981). In the instant case, clearing and settling a transaction constitute conditions precedent because the customer has no duty to pay a commission until those events have occurred and the customer receives the securities or cash, as the case may be. In contrast, a "condition subsequent" is any event the existence of which, by agreement of the parties, operates to discharge a duty of performance that has already arisen. Calamari & Perillo, supra, at 441; RESTATEMENT (SECOND) CONTRACTS § 230 (1981).

have occurred. If nothing further were affirmatively to happen after the trade date, Schwab's customer would not receive the securities or cash from the transaction in question. And Schwab would not have earned its commission under its contract with its customer. Schwab's activities between the trade and settlement dates are therefore not conditions subsequent, but are acts that Schwab must affirmatively perform if it is to earn its income.

The lower courts nonetheless brushed aside both common sense and the contractual prerequisites to Schwab's right to be paid its commission, by characterizing settlement — as well as other post-trade-date activities — as "conditions subsequent." This characterization highlights the conflict between the present case and General Dynamics, supra. Under General Dynamics, a contractual condition to a right to payment must be a condition precedent and cannot be a condition subsequent.

C. The Inherent Ambiguities of the Lower Courts' Standard Will Confuse the Nation's Taxpayers and Burden the Courts.

A result of the lower courts' mistakes of law is an irremediably ambiguous "essential" vs. "ministerial" acts standard that invites the Commissioner and the courts to substitute their own subjective judgments about what is "essential" to the performance of a contract for the objective determination of whether all contractually required acts have been performed to fix the right to income. Under the lower court's decision, taxpayers will need to divine at what point partial performance is sufficient to trigger income accrual

even though that performance falls short under the contract. And courts, at the Commissioner's insistence, will struggle to apply unhelpful distinctions in the hope of finding what the contract was "really" about. Under the lower courts' decision, the "all" part of the "all events" test becomes a misnomer. And if fewer than "all" events are deemed to satisfy the test, both taxpayers and the courts will be reduced to guessing when income has been earned.

The accrual standard established by this Court in General Dynamics has the considerable virtue of being hard-edged and clear in its application: All contractual pre-requisites to payment (or liability) must be satisfied before accrual occurs. Under the Ninth Circuit and Tax Court decision, only those pre-requisites that are "essential" to performance of the contract need occur. However, the term "essential" does not have a clear meaning, but is likely to vary in meaning from taxpayer to taxpayer.

The instant case is an example. The Tax Court's finding that Schwab's "essential" service is the matching of buyers and sellers on the trade date "through its access to the securities exchanges" was not based on evidence or stipulations regarding customers' reasons for patronizing Schwab, but rather on the court's observation that this access gives "the customer ... the ability to make a trade." Schwab respectfully submits, however, that for virtually all of its customers the "essential" feature of Schwab's business is that, with a very high degree of certainty, orders placed with Schwab result in a settled transaction that secures for a seller the cash from the sale and for a buyer the securities purchased. For these customers, Schwab's access to the

exchanges is a necessary, but not sufficient, element of Schwab's business. It is possible that for some customers, the matching process on the trade date is "essential." Under the lower courts' standard, what should Schwab do to assure accurate accrual accounting? Poll its customers? Accrue income on the trade date for those who agree with the Tax Court and the Ninth Circuit and on the settlement date for those who believe it is "essential" to have cash in hand?[8] Or does the decision of the courts below mean that matching of buyers and sellers is the essential element whatever Schwab's customers — and Schwab itself — actually believe?

The implications of the lower court's decision reach far beyond brokerage firms and service businesses. Consider, for example, a manufacturer of heavy industrial components that maintains both an extensive inventory and a fleet of specialized trucks to make deliveries. For customers in sudden need of a replacement part, the manufacturer's ability to make rapid, assured deliveries may be the "essential" feature, of buying from this manufacturer. For others, the availability of an extensive inventory may be the "essential" feature, and these customers may be relatively indifferent to the timing of delivery. Moreover, the quality that a customer believes to be "essential" may change from month to month or week to week: When the need is sudden, delivery is "essential." When the need is predictable,

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[8] Any such need to differentiate among customers would in itself impose an enormous burden on Schwab's business. During the taxable years in issue, Schwab averaged more than 10,000 transactions per business day.

availability of the component from inventory may be "essential." Under the Ninth Circuit and Tax Court decision, the manufacturer's accounting for sales would change depending upon the needs of the particular customer at the time the order is placed, even though the manufacturer's business practices would be the same for each category of sale.

Or consider a contractor building custom homes to order. Under General Dynamics, the contractor's income would accrue when the construction required by the contract is complete. Under the Ninth Circuit/Tax Court standard, however, the contractor must instead ask itself when the "essential" features of a home are complete. It seems certain that the foundation, walls, and roof would be considered "essential." Wiring and plumbing are probably also "essential." Cabinetry? Uncertain — possibly "essential" possibly "ministerial." Bathroom tile? Again uncertain, but one would guess "ministerial." Carpeting? Probably "ministerial." Kitchen appliances? Probably "ministerial." Painting? Definitely "ministerial." So when, according to the Ninth Circuit and the Tax Court, does the contractor accrue its income? Not upon completion of its contract, but sometime between the time the cabinets are finished and the paint dries, depending upon the collective views of the contractor, the Commissioner and, inevitably, the courts. Moreover, it is a safe guess that different courts will have different views of which features of different taxpayers' businesses are "essential" and which are "ministerial."

Due to this very lack of clarity, the decision of the Tax Court and the Ninth Circuit would bedevil the nation's

corporate taxpayers — and ultimately the courts — as they try to figure out which of the acts a taxpayer performs to earn its income are substantive and important and which are merely "ministerial" (or "conditions subsequent" instead of "conditions precedent").

CONCLUSION

For the foregoing reasons, this Court should grant this Petition and issue a writ of certiorari to the Ninth Circuit.

Respectfully submitted,

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APPENDIX A
ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT AFFIRMING THE DECISION OF THE UNITED STATES TAX COURT, FILED DECEMBER 9, 1998

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

NO. 97-70917

CT/AG#: 1271-92

THE CHARLES SCHWAB CORPORATION AND INCLUDABLE SUBSIDIARIES

Petitioner — Appellant

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent — Appellee

On Appeal from the United States Tax Court.

THIS CAUSE came on to be heard on the Transcript of the Record from the Internal Revenue Service and was duly submitted.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court, that the decision of the said United States Tax Court in this cause be, and hereby is AFFIRMED.

Filed and entered December 9, 1998.

APPENDIX B
OPINION OF THE UNITED STATES TAX COURT
FILED NOVEMBER 14, 1996

107 T.C. NO. 17

UNITED STATES TAX COURT

THE CHARLES SCHWAB CORPORATION AND INCLUDABLE SUBSIDIARIES,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

Docket No. 1271-92 Filed November 14, 1996.

P, an accrual basis taxpayer, provides discount securities brokerage services for which it earns a commission fee. As a discount broker, P does not engage in activities, such as research and portfolio management, that are normally conducted by a full-service broker. P executes a customer's order to buy or sell securities on the trade date, but the securities are not actually transferred and payment is not due until the settlement date, which was generally 5 days after the trade date. Between those dates, P performs certain functions to record, confirm, and book the customer's trade.

P commenced business in the State of California on Apr. 1, 1987. P deducted its California franchise taxes based on income for its first year ended Dec. 31, 1987, on its Federal income tax return for the taxable year ended Mar. 31, 1988. P then changed to a calendar year for Federal income tax purposes and is attempting to deduct its California franchise taxes based on income for its second year on its Federal income tax return for the taxable year ended Dec. 31, 1988.

Held: Under the "all events" test, P must accrue commission income for the purchase or sale of securities on the trade date as opposed to the settlement date.

Held, further: Under California law, P's liability for franchise taxes based on its income during its second year ended Dec. 31, 1988, was fixed on that date. Sec. 461(d), I.R.C., which would act to disallow the accrual of State taxes "to the extent that the time for accruing taxes is earlier than it would be but for any action of any taxing jurisdiction taken after December 31, 1960" does not apply because under California law as it existed prior to Dec. 31, 1960, all events fixing P's liability for franchise tax based on income earned during its second year would have accrued on Dec. 31 of its second year.

Philip C. Cook, Terence J. Greene, Timothy J. Peaden, Karen S. Sukin, Ben E. Muraskin, Michelle M. Henkel, Glenn A. Smith, Michael R. Faber, Teresa A. Maloney, for petitioner.

Usha Ravi, Steven A. Wilson, and Emily Kingston, for respondent.

RUWE, Judge: Respondent determined deficiencies in petitioner's Federal income taxes for the taxable years ending March 31, 1988, and December 31, 1988, in the amounts of $16,136,176 and $12,146,497, respectively.

After concessions, the issues remaining for decision are: (1) Whether petitioner must accrue brokerage commission income on the date a trade is executed or on the settlement date; and (2) whether petitioner is entitled to a deduction for its California franchise tax liability in the amount of $932,979 on its Federal income tax return for the 9-month period ending December 31, 1988.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and supplemental stipulation of facts are incorporated herein by this reference. At the time its petition was filed, petitioner's principal place of business was located in San Francisco, California.

Petitioner is a consolidated group consisting of The Charles Schwab Corp.; its first-tier subsidiary, Schwab Holdings, Inc.; and its second-tier operating subsidiary, Charles Schwab & Co., Inc. Petitioner provides discount securities brokerage and related financial services, primarily to individuals, throughout the United States. During the years in issue, petitioner was a member of all major U.S. securities exchanges and had software links with all registered U.S. securities exchanges, major dealers, the National Securities Clearing Corp., and the Depository Trust Co. During the relevant years, petitioner filed consolidated Federal income tax returns and computed its taxable income under the accrual method of accounting.

Charles Schwab & Co., Inc., the operating subsidiary, was incorporated in 1971 as the First Commander Corp. under the laws of the State of California. First Commander Corp. changed its name to Charles Schwab & Co., Inc. (Schwab & Co.), in 1973 after Charles R. Schwab became its owner and chief executive officer.

Schwab & Co. initially conducted a retail securities brokerage business from a single office in California and published an investment advisory newsletter. In 1974, Schwab & Co. took advantage of a trial period during which the Securities & Exchange Commission (SEC) permitted discounts on securities commissions. On May 1, 1975, the SEC abolished fixed commission rates, and Schwab & Co. engaged exclusively in discount securities brokerage transactions by focusing its marketing efforts on investors who wished to conduct their own research, make their own

investment decisions, and avoid paying brokerage commissions for research, advice, and portfolio management.

In November 1982, Schwab & Co.'s parent company, Schwab Holdings, Inc. (which, at that time, was called The Charles Schwab Corp.), agreed to merge into BankAmerica Brokerage Co. (BBC), a wholly owned subsidiary of BankAmerica Corp. (BankAmerica). As a result of the merger, Schwab & Co. became a wholly owned subsidiary of BBC. In January 1983, EEC changed its name to The Charles Schwab Corp.

On March 31, 1987, Charles R. Schwab, through CL Acquisition Corp. (currently known as The Charles Schwab Corp.), purchased from BankAmerica the stock of The Charles Schwab Corp. (formerly BBC and currently known as Schwab Holdings, Inc.), and its wholly owned subsidiary, Schwab & Co., in a management-led leveraged buyout.

Commission Income Issue

One of petitioner's primary sources of revenue is commission income, which is earned by effecting sales and purchases of stocks and other securities for its customers in a rapid, efficient, and cost effective manner.

The primary service performed by petitioner in effecting sales and purchases of stocks and securities on behalf of customers is the execution of trade orders. Petitioner does not engage in many of the other activities in which full-commission, full-service brokerage firms engage, such as underwriting, market-making, arbitrage, research, and portfolio management. Petitioner also does not solicit transactions in any particular security and does not offer

investment advice to its customers about the nature, potential value, or suitability of any particular security. Nor does petitioner exercise any discretionary authority over customer accounts or, with certain limited exceptions, engage in principal transactions in any security.

Petitioner's strategy is to serve self-directed customers, focusing on those who do not need or want to pay, through commissions, for research, investment advice, or portfolio management. As a result, a customer could save up to 76 percent compared to rates charged by full-commission brokers. By concentrating on unsolicited transactions on an agency basis, petitioner substantially avoids the risk of losses and liabilities faced by full-commission firms that engage in investment banking, underwriting, market-making, arbitrage, and other advisory and principal activities. Moreover, petitioner's customers are not assigned to a particular representative but, instead, may trade with any available representative. As a result, the departure of a registered representative from petitioner does not typically result in a loss of customers.

The "trade date" is the day a trade occurs. On this day, a customer's order is executed by locating a seller or purchaser for securities on terms acceptable to the customer. The date on which petitioner settles the accounts of a customer whose order to buy or sell securities has been executed is termed the "settlement date". Settlement is the process of transferring payment from buyer to seller and certificates from seller to buyer. When customers buy securities, petitioner must receive the full confirmed amount due no later than the settlement date. When customers sell

securities, petitioner must receive the stock certificates, properly endorsed, by the settlement date.

In 1988, there was no Federal rule that mandated a specific settlement cycle for securities transactions.[1] Instead, the settlement cycle in the United States varied among markets and was largely a function of market custom, exchange rules, and industry practice. The rules of the New York Stock Exchange, however, required transactions to be settled no later than the fifth business day after the trade date.

After a customer's order is received, petitioner transmits the order to the exchange floor for execution via the exchange's system or through floor brokers. A report of execution, which lists the transactions in terms of shares purchased or sold, but not by customer name or account number, is returned to the firm as a trade record. After the trade is executed and while the customer is still on the telephone, petitioner can verbally confirm the execution for "market" orders[2] placed via telephone while the markets are open. The price paid or received by the customer for the purchase or sale of securities is determined according to the market price in effect on the trade date.

Petitioner must perform a series of functions after the order is placed and the trade executed. These functions,

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[1] See infra note 4.

[2] A "market" order is an order from a customer to buy or sell securities as soon as practicable at the then-current market price. This is in contrast to a "limit" order, which is an order to buy or sell securities when the market reaches a price level specified by the customer.

which are performed up until settlement, consist of (i) recording, (ii) figuration, (iii) confirmation, (iv) comparison, and (v) booking.

In the recording function, each transaction is coded, and each trade is assigned a number that identifies the issuer and the issue. The place of execution (i.e., a stock exchange) is also coded along with any other details needed to process the trade properly.

In the figuration function, petitioner computes the contract money, commission to be earned, taxes, fees, and all other related money amounts associated with the trade during nightly batch processing on the day the trade is executed. The net is the amount that the customer must pay in the case of a purchase or is entitled to receive in the case of a sale. The results of the figuration function are available, in written format, on the morning following the trade date. In addition, petitioner can apprise a customer of the commission cost of any trade at the time of the execution of the trade by accessing a computer screen designed to compute commissions on customer trades.

The confirmation function involves mailing a written notification to the customer, usually on the first business day after the trade is executed. The confirmation serves as an invoice and written notification of the trade. The confirmation contains the following information: (1) A description of the trade, including the name of the security, quantity, execution price, settlement money, commission, and other fees; (2) trade date; (3) settlement date; (4) place of execution; (5) capacity in which the firm acted; (6) customer's name and address; (7) customer's account

number; (8) type of customer account; and (9) the amount due. Petitioner also encloses a remittance stub and a return envelope with the confirmation.

The comparison function, which is required by the National Association of Securities Dealers, Inc., and which generally begins on the first day following the trade date, is the process by which customers' trades are balanced or reconciled against the opposing brokerage firm's transactions. This is done through the clearing facilities of the exchanges where petitioner holds memberships. In addition to the broker-to-broker comparison, petitioner also compares the report of execution to its trade record, which represents the customer's order.

Petitioner and the clearing facility attempt to resolve "uncompared trades" (i.e., those trades whose terms do not match or compare in some respect between petitioner and the opposing firm) by the next business day following the execution of a customer order. However, the resolution of open items continues until all trades are balanced, which may not occur until the settlement date, to ensure that petitioner is not undergoing any undue risk. If petitioner has an uncompared trade that was unreconciled, it will be required to enter the marketplace and buy or sell to cover the trade.

In the booking function, the customer's transaction is entered on petitioner's records, including the recording of fees and commissions due to petitioner.

Unlike many other discount brokers, who depend on third-party vendors, petitioner performs all execution, clearing, and account maintenance functions for its

customers. This enables petitioner to gain greater control over the quality of customer service and to retain free credit balances and securities for use in margin lending.

On the settlement date, petitioner physically effects the delivery of the securities and receipt of the sale price, in the case of a sale, or receipt of the securities and delivery of the purchase price, in the case of a purchase. When a customer of petitioner sells securities that are not held by petitioner in street name,[3] the certificates must be properly endorsed and received by petitioner by settlement date. If a customer of petitioner already has sufficient funds in his or her account, petitioner automatically uses these funds on the settlement date to pay for securities purchased, even though the confirmation indicated an amount due. If petitioner does not receive payment for securities purchased by the customer by the settlement date, petitioner reserves the right to cover the position, and the customer is responsible for any loss resulting from the execution of the trade order.

A security is not debited or credited to the customer's account until the actual settlement date. The settlement date is also important for purposes of determining who is entitled to receive dividends paid on stock and interest that has accrued on bonds. Dividends are paid to the holders of record (i.e., those persons in whose name the stock is

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[3] Securities are said to be carried in "street name" when they are held in the name of the broker instead of the customer's name. Holding securities in street name allows for ease of transfer by the broker and convenience to the customer, because it avoids the necessity of obtaining the customer's endorsement to transfer the security.

registered). If a transaction occurs, but does not settle prior to the dividend record date or if the security is not re-registered in the new name by the record date, the buyer is not entitled to the dividend. Bonds trade at market price plus accrued interest. Interest continues to accrue to the bond's seller up to, but not including, the settlement date.

As a general rule, petitioner does not permit cash and next-day orders. In the event of customer hardship, such as a medical emergency or an escrow closing, however, proceeds from a sale can be paid to a customer prior to settlement. In such instances, the customer is charged a special prepayment fee of the greater of $10 or 0.2 percent of principal in addition to the standard commission for the trade.

There was generally a 5-day delay between the trade and settlement dates. The 5-day delay between the trade and settlement dates allows sufficient time to reflect the trade in petitioner's books and records and to deliver the securities. The securities clearance and settlement system is exposed to several sources of risk including market risk, participant or credit risk, and external risk, such as a domestic or international event. A reduction of the time between trade execution and settlement can make the settlement cycle safer, but such reduction is not without obstacles, which would require changing established settlement practices and educating retail and institutional investors.[4]

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[4] The SEC adopted a new rule under the Securities Exchange Act of 1934, ch. 404, 48 Stat. 881, which establishes a 3-business-day settlement period for broker-dealer trades, effective June 1, 1995. 17 C.F.R. sec. 240.15c6-1 (1996). The new rule is designed to: (i) Reduce

(footnote continued...)

Mistakes can occur in placing the customer order, such as trading the wrong security or quantity of securities, selling the security when instructed to buy and vice versa, or performing figuration incorrectly. Petitioner determines if the error is a representative error or a customer error by reviewing a tape recording of the telephone order, if available.

No customer of petitioner can cancel an order that is executed in accordance with the customer's instructions. If petitioner made an error, the customer is made whole by canceling the transaction and rebilling it. When transactions are canceled and rebilled, new trade confirmations are generated and sent to the customer, showing both the canceled trade information and the corrected trade information. When petitioner cancels and rebills a customer for a trade that it incorrectly executed, the customer is liable only for the amount determined according to circumstances existing on the original trade date.

(continued from previous page)

settlement risk, the risk to clearing corporations, their members, and public investors inherent in settling securities transactions by reducing the number of unsettled trades in the clearance and settlement system at any given time; (ii) reduce the liquidity risk among the derivative and cash markets and reduce financing costs by allowing investors that participate in both markets to obtain the proceeds of securities transactions sooner; and (iii) facilitate risk reduction by achieving closer conformity between the corporate securities markets and Government securities and derivative securities markets that currently settle in fewer than 5 days. 58 Fed. Reg. 52891 (Oct. 13, 1993).

Individual trades may be canceled if an entire transaction is canceled. For example, a customer's trade would be canceled if an initial public offering were canceled after trading was initiated. In these instances, the trades never settle and petitioner collects no commission.

For the taxable year ended December 31, 1988, petitioner accrued commission income on the purchase or sale of securities on the settlement date for tax and book purposes. Petitioner's trades that were executed in 1988, but settled in 1989, resulted in $3,357,576 net commission income.

Franchise Tax Issue

Petitioner qualified to do business in California on February 9, 1987. Petitioner commenced business in California on April 1, 1987.

Petitioner elected a calendar taxable year for California income and franchise tax purposes. Petitioner's first Federal taxable year ended on March 31, 1988, but petitioner changed its Federal taxable year to a calendar year for its second and subsequent years.

Petitioner reported California franchise tax in the amount of $879,500 on its first California Franchise or Income Tax Return (Form 100) for the income year ending December 31, 1987, and paid such amount with its return. Petitioner deducted this amount on its Federal return filed for the taxable year ended March 31, 1988.

For the income year ending December 31, 1988, petitioner reported California franchise tax in the amount of

$932,979 on its second California Franchise or Income Tax Return (Form 100) and paid such amount with its return. On its Federal return filed for the taxable year ended December 31, 1988, petitioner did not deduct the franchise tax that it paid for California income year 1988. Petitioner now claims that this was an error and that it should be entitled to deduct the 1988 franchise tax for its taxable year ended December 31, 1988.

OPINION

Commission Income Issue

The first issue we must decide is whether petitioner, an accrual basis taxpayer, must accrue brokerage commission income on the trade date or on the settlement date. Neither party cites, nor did we find, any cases directly on point.[5] The question of when an accrual basis securities broker must accrue commissions earned on securities transactions appears to be one of first impression.

Petitioner kept its books and records and filed its income tax returns using the accrual method of accounting. Under the accrual method, income is to be included for the taxable year when (1) all the events have occurred that fix the right to receive such income, and (2) the amount can be determined with reasonable accuracy. Secs. 1.446

[5] We note that in Rev. Rul. 74-372, 1974-2 C.B. 147, the IRS ruled that a stock brokerage business using the accrual method of accounting must accrue commission income on the trade date, rather than on the settlement date. Respondent's position herein is consistent with this ruling.

1(c)(1)(ii), 1.451-1(a), Income Tax Regs. The parties do not dispute that the second prong of the test--that the amount of the commissions can be determined with reasonable accuracy--is met as of the trade date. Our discussion is thus limited to whether petitioner had a fixed right to receive the commission income as of that date.

Under the all events test, it is the fixed right to receive the income that is controlling and not whether there has been actual receipt thereof. Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-185 (1934). The taxpayer's right to receive income is fixed upon the earliest of (1) the taxpayer's receipt of payment, (2) the contractual due date, or (3) the taxpayer's performance. See Schlude v. Commissioner, 372 U.S. 128, 133, 137 (1963); Cox v. Commissioner, 43 T.C. 448, 456-457 (1965). An accrual basis taxpayer must report income in the year the right to such income accrues, despite the necessity for mathematical computations or ministerial acts. Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 295-297 (1932) ; Dally v. Commissioner, 227 F.2d 724 (9th Cir. 1955), affg. 20 T.C. 894 (1953); Resale Mobile Homes, Inc. v. Commissioner, 91 T.C. 1085, 1095 (1988) , affd. 965 F.2d 818 (10th Cir. 1992). Moreover, the fact that a taxpayer cannot presently compel payment of the money is not controlling. Commissioner v. Hansen, 360 U.S. 446, 464 (1959)

Petitioner argues that its commission is earned when delivery of the securities and payment of the purchase price occur, which is not until the settlement date. According to petitioner, the acts that it performs between the trade date and the settlement date are not merely ministerial. Rather,

they are integral parts of the service for which it is paid a commission, and they represent a substantial percentage of the total discount brokerage services provided. Respondent, on the other hand, argues that execution of an order on behalf of a customer is the essential service that petitioner performs and is the time at which petitioner's right to receive, and the customer's obligation to pay, the commission arises. According to respondent, all the actions that remain to be performed by petitioner after the trade date are of a ministerial nature to effectuate the mechanics of the transfer and are merely in confirmation of the trade executed. We agree with respondent.

Petitioner is a member of all major U.S. securities exchanges. The essential service that petitioner provides to its customers is the execution of trades through its access to the securities exchanges. It is through this access that the customer acquires the ability to make a trade. Indeed, petitioner's statement of Terms and Conditions, which states the agreement between petitioner and the customer, provides that petitioner "executes orders for securities only and does not give investment advice." There is no mention of posttrade services, such as recording, confirmation, or booking.

Moreover, the price of the securities that a customer purchases or sells and the amount of commission due to petitioner are determined as of the trade date. If petitioner does not receive payment on a purchase or sale order executed for the customer, it liquidates the customer's account to collect the amount, including the commission, determined on the trade date. Upon execution of a customer

order, a written confirmation is generated automatically and is sent to the customer on the next business day following the trade date. The written confirmation serves as an invoice and as written notification to the customer of the trade. The confirmation statement itemizes the total cost of the trade, including the amount of the commission, and lists the total "amount due". Petitioner encloses a remittance stub and a return envelope with the confirmation. The customer does not have the right to cancel an order that petitioner executes in accordance with the instructions of the customer.

In applying the all events test, this and other courts have distinguished between conditions precedent, which must occur before the right to income arises, and conditions subsequent, the occurrence of which will terminate an existing right to income, but the presence of which does not preclude accrual of income. Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 217-218 (2d Cir. 1952), affg. in part and revg. in part 16 T.C. 882 (1951); Wien Consol. Airlines, Inc. v. Commissioner, 60 T.C. 13, 15 (1973), affd. 528 F.2d 735 (9th Cir. 1976); Buckeye Intl., Inc. v. Commissioner, T.C. Memo. 1984-668; see also Resale Mobile Homes, Inc. v. Commissioner, 965 F.2d 818, 824 (10th Cir. 1992), affg. 91 T.C. 1085 (1988).[6]

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[6] Although Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 217-218 (2d Cir. 1952), affg. in part and revg. in part 16 T.C. 882 (1951), Wien Consol. Airlines, Inc. v. Commissioner, 60 T.C. 13, 15 (1973), affd. 528 F.2d 735 (9th Cir. 1976), and Buckeye Intl., Inc. v. Commissioner, T.C. Memo. 1984-668, involved the accrual of deductions rather than the proper reporting of income, this Court has recognized that similar considerations apply with respect to both issues.

(footnote continued...)

We think the above factors indicate that petitioner's execution of a trade for a customer is a condition precedent that fixes petitioner's right to receive the commission income. The functions that remain to be performed by petitioner after the trade date are of a ministerial nature to effectuate the mechanics of the transfer and confirm the trade executed. Although failure to perform these functions may ultimately divest petitioner of its right to the commission income, we think that these functions are conditions subsequent and, therefore, do not preclude accrual of commission income on the trade date.

Nor does the possibility that an executed trade may not settle due to cancellation of an entire public offering make petitioner's right to the commission income too indefinite or contingent for accrual. See Brown v. Helvering, 291 U.S. 193, 199-200 (1934) (holding that overriding commissions received by a general agent for policies written must be accrued even though there was a contingent liability to return a portion of the commission in the event the policy was canceled); Georgia School-Book Depository, Inc. v. Commissioner, 1 T.C. 463, 468-470 (1943) (holding that a book broker that represented publishers in sales of school books to the State of Georgia must accrue commission income, despite the fact that the State was obligated to pay for the books only out of a particular fund, and, during the years in issue, the fund was insufficient to pay for the books

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See Simplified Tax Records, Inc. v. Commissioner, 41 T.C. 75, 79 (1963); Buckeye Intl., Inc. v. Commissioner, supra.

in full). The possibility that a trade might not finally be settled is, if anything, a condition subsequent to the execution of the trade, which was the event that fixed petitioner's right to the commission. See Central Cuba Sugar Co. v. Commissioner, supra at 217-218 (holding that sales commission expenses were deductible in the year the taxpayer entered the contract for sale even though they were not payable until delivery, and even though the commission expenses were subject to adjustment in accordance with final weighing before shipment and forfeiture if the contract were not carried out).

Petitioner argues that unlike full-commission securities brokers who engage in a full range of activities, such as research and portfolio management, the functions performed by petitioner between the trade and settlement dates represent a substantial percentage of the services provided by petitioner to its brokerage customers. According to petitioner, the commission income received by petitioner does not represent payment for investment advice or other pretrade services, but rather is a fee for the specific services of executing the transaction and handling the mechanics of the transfer of title and delivery on the settlement date. Therefore, petitioner argues, even if the posttrade activities conducted by a full-commission broker are considered ministerial, they cannot be considered ministerial when performed by a discount broker such as petitioner.

While we appreciate the differences in the services provided by full-commission and discount brokers, we cannot agree that ministerial acts that constitute conditions subsequent to a customer's obligation to pay commissions

are converted to conditions precedent merely because they may comprise a significant percentage of the overall activities conducted by the broker.

Petitioner argues that this case is governed by Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26 (1988). In Hallmark, a manufacturer and seller of greeting cards shipped its Valentine merchandise to customers in the year prior to that in which the holiday occurred. The terms of the sale specified that title and risk of loss did not pass to the customer until January 1 of the year following the shipment. This Court held that the taxpayer's right to income from the sale became fixed only upon passage of title and risk of loss to the purchasers, notwithstanding that delivery of the goods had occurred earlier. Id. at 32-33. Petitioner argues that because title to the securities does not pass, and petitioner is not relieved of its risk of loss until the settlement date, its right to the commission income is not fixed until the settlement date.

Hallmark v. Commissioner, supra, is distinguishable from the instant case. In Hallmark, the taxpayer was a manufacturer and seller of goods. Thus, passage of title and risk of loss constituted the essence of the transaction; without such passage, no sale occurred. Conversely, the present case involves a service provider that executes securities trades as an agent of its customers. We think that the focus in this case must be on the contractual relationship between petitioner and its customer, not on the relationship between

the customer and the purchaser or seller of the securities.[7] The agreement between petitioner and its customers was that any trade executed by petitioner in accordance with the customer's instructions could not be canceled. In contrast, the customer in Hallmark had the right to return the merchandise without penalty until title passed. Id. at 33. The essence of the transaction between petitioner and its customer is the execution of a trade on behalf of the customer.

Accordingly, we uphold respondent's determination that petitioner must accrue commission income for the purchase or sale of securities on the trade date as opposed to the settlement date.

California Franchise Tax Issue

The next issue we must decide is whether petitioner is entitled to a deduction for its California franchise tax liability in the amount of $932,979 on its Federal income tax return for the taxable year ended December 31, 1988. Respondent does not dispute that petitioner properly deducted $879,500 on its Federal return for the taxable year ended March 31, 1988, for the franchise tax it paid for the

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[7] We note, however, that the legislative history of the Tax Reform Act of 1986 indicates that for Federal income tax purposes, both cash and accrual method taxpayers must recognize gain or loss on the sale of securities traded on an established market on the date the trade is executed. S. Rept. 99-313 (1986), 1986-3 C.B. (Vol. 3) 131. Such treatment, while not controlling as to brokerage commissions, is consistent with our holding herein.

California income year 1987. Regardless of whether the franchise tax properly accrued on December 31, 1987, as petitioner contends, or on January 1, 1988, as respondent contends, both parties agree that the deduction was proper in petitioner's first Federal taxable year. Instead, the parties' dispute centers on the deductibility of the California franchise tax for petitioner's second Federal taxable year.

To understand the crux of the dispute, it is necessary to understand some of the history with respect to the California franchise tax. California imposes an annual franchise tax on most corporations doing business within the State of California for the privilege of exercising their corporate franchises. Cal. Rev. & Tax. Code sec. 23151(a) (West 1992). In general, the tax computed for the "taxable year"[8] is based upon the net income of the preceding year, which is designated the "income year". Id. secs. 23041(a), 23042(a), 23151(a) (West 1992).

Prior to the 1972 amendments to the California franchise tax statutes, the California franchise tax generally accrued on the first day of the taxable year. In Central Inv. Corp. v. Commissioner, 9 T.C. 128, 132-133 (1947), affd. per curiam 167 F.2d 1000 (9th Cir. 1948), we held that even though the California franchise tax was measured by the preceding year's income, accrual basis taxpayers could accrue the tax only during the taxable year. Under pre-1972 law, withdrawal or dissolution relieved the taxpayer from

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[8] The "taxable year" is the year for which the California franchise tax is payable. Cal. Rev. & Tax. Code sec. 23041(a) (West 1992)

taxation for the period of the taxable year during which the corporate franchise was not exercised. The tax was essentially a tax on the privilege of doing business in the taxable year. Id. at 133. All events fixing a corporation's liability for the California franchise tax did not occur until the taxable year in which it exercised its privilege. Epoch Food Serv., Inc. v. Commissioner, 72 T.C. 1051, 1053 (1979)

In 1972, California amended its franchise tax law so that withdrawal or dissolution would no longer relieve a taxpayer from tax based on the preceding year's income. In Epoch Food Serv., Inc. v. Commissioner, supra at 1054, we found that the effect of this amendment was to change the accrual date for the tax from January 1 of the taxable year to December 31 of the income year. Thus, after the 1972 amendment, the event fixing the liability for the California franchise tax is the earning of net income in the income year, rather than the exercising of the corporate franchise in the taxable year. Id.

Section 164(a) permits a deduction for State taxes during the taxable year in which paid or accrued. However, section 461(d) overrides the normal rules for accruing taxes in certain situations. Section 461(d)(1) provides:

> In the case of a taxpayer whose taxable income is computed under an accrual method of accounting, to the extent that the time for accruing taxes is earlier than it would be but for any action of any taxing jurisdiction taken after December 31, 1960, then, under regulations prescribed by the Secretary, such

> taxes shall be treated as accruing at the time they would have accrued but for such action by such taxing jurisdiction.

Under the regulations, any action of a taxing jurisdiction that would accelerate the time for accruing a tax is to be disregarded in determining the time for accruing such tax for purposes of the deduction allowed under section 164(a). Sec. 1.461-1(d)(1) Income Tax Regs. This applies to a taxpayer upon which the tax is imposed at the time of the taxing jurisdiction's action, as well as a taxpayer upon which the tax is imposed at any time subsequent to such action. Id.

Respondent argues that section 461(d)(1) governs and that petitioner may not accrue any deduction for California franchise taxes based on 1988 income until 1989. Petitioner, on the other hand, argues that respondent's position fails to take into account the special California statutory rules that applied to a commencing corporation's first and second income and taxable years under pre-1972 California franchise tax law. Petitioner contends those rules would have applied to petitioner's first and second taxable years so that under the pre-1972 State law, petitioner's liability would have become fixed on December 31, 1988, for the $932,979 franchise tax based on its 1988 income. Thus, petitioner argues that the 1972 amendments did not accelerate the accrual of its California franchise tax and that section 461(d)(1) and the cases interpreting that section with respect to California law are inapplicable. See Epoch Food Serv., Inc. v. Commissioner, supra; Central Inv. Corp. v.

Commissioner, supra; see also Hitachi Sales Corp. of Am. v. Commissioner, T.C. Memo. 1992-504.

The general rule for a taxpayer that commenced business in California before 1972 was that the franchise tax for the taxpayer's first taxable year was based upon the income received during that year and that the income for the first taxable year also served as the measure of the franchise tax for the taxpayer's second taxable year. Cal. Rev. & Tax. Code sec. 23222 (a) (West 1992). Thereafter, the tax due for each taxable year was based on the income earned in the next preceding income year. Id. sec. 23151(a). However, a special rule applied where the commencing corporation's first taxable year was less than 12 months:

> In every case in which the first taxable year of a taxpayer constitutes a period of less than 12 months, or in which a taxpayer does business for a period of less than 12 months during its first taxable year, said taxpayer shall pay as a prepayment of the tax for its second taxable year a tax based on the income for the first taxable year computed under the law and at the rate applicable to the second taxable year, the same to be due and payable at the same times and in the same manner as if that amount were the entire amount of its tax for that year; and upon the filing of its tax return within 2 months and 15 days after the close of the second taxable year it shall pay a tax for said year, at the rate applicable to that year, based upon its net income received during

> that year, allowing a credit for the prepayment; but in no event, except as provided in Section 23332, shall the tax for the second taxable year be less than the amount of the prepayment for that year, and said return for its second taxable year shall also be the basis for the tax of said taxpayer for its third taxable year, if the second taxable year constitutes a period of 12 months. [Id. sec. 23222(a).]

Cal. Rev. & Tax Code sec. 23222(a) was in effect prior to December 31, 1960. Thus, prior to December 31, 1960,[9] where a taxpayer's first taxable year was a period less than 12 months, the income from the short year was not used as the basis for computing the franchise tax for the second taxable year; rather, the income earned in the taxpayer's second taxable year was used as a measure of its franchise taxes for the second taxable year.

Petitioner argues that under the law as it existed prior to December 31, 1960 (prior to the 1972 amendment), its first year ending December 31, 1987, constituted both its first income year and its first taxable year, and that its franchise tax liability based on 1987 income would have become fixed on the last day of 1987, even if petitioner had dissolved on January 1, 1988. Similarly, petitioner argues

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[9] Pursuant to the 1972 amendment, sec. 23222(a) of the Cal. Code applies only to taxpayers who commenced doing business in California prior to Jan. 1, 1972. Cal. Rev. & Tax Code sec. 23222(b) (West 1992).

that since its first taxable year was a period less than 12 months, its second taxable year (the taxable year in issue) and income year would also have been the same, and, thus, the franchise tax based on its second year's income would have accrued on December 31, 1988. We agree.

None of our prior opinions dealt with a situation where the income year and the taxable year would have been the same for purposes of the franchise tax as it applied prior to December 31, 1960. However, that is the result of applying section 23222(a) of the California code, as it existed prior to the 1972 amendment, to the facts of this case. Pursuant to that section, the franchise tax for petitioner's first taxable year ended December 31, 1987, would have been computed on income earned during that period and would have been payable to the State for the privilege of exercising the corporate franchise for the same period. This franchise tax based on income received during the first year would have been due regardless of whether petitioner exercised its privilege after the close of its first year.

Because petitioner's first taxable year for franchise tax purposes was for a period of less than 12 months, prior to the 1972 amendment, Cal. Rev. & Tax Code sec. 23222(a) would have required petitioner to pay a franchise tax based on its income for the second year for the privilege of exercising the corporate franchise during the second year. The franchise tax liability based on income earned during the second year would not have depended upon the occurrence

of an event subsequent to the end of the second year.[10] All events necessary to fix petitioner's liability for franchise tax in the amount of $932,979 based on income earned during its second year would have occurred at the end of the second year under the law as it existed prior to December 31, 1960. It follows that petitioner's liability to the State of California for franchise tax based on income earned during its second year, which ended December 31, 1988, would have accrued at the end of its second taxable year, regardless of the 1972 amendment to the franchise tax. We hold that section 461(d) does not prevent petitioner from accruing its liability for franchise tax in the amount of $932,979.

Respondent argues that even if petitioner's liability for the franchise tax in the amount of $932,979, is otherwise accruable in 1988, petitioner should not be allowed the deduction because it would constitute a change in petitioner's accounting method to which respondent has not consented. We disagree.

Petitioner used the accrual method of accounting. It apparently did not accrue the $932,979 on its Federal income tax return because it relied on Rev. Rul. 79-410, 1979-2 C.B. 213. That ruling relied on section 461(d) and the premise that prior to 1972, California corporations could not

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[10] Under Cal. Rev. & Tax Code sec. 23222(a), as it applied prior to 1972, the second taxable year would also have been the income year for purposes of computing the franchise tax for petitioner's third taxable year. Prior to the 1972 amendment, the franchise tax for the third taxable year would not be accruable until Jan. 1, 1989, and the franchise tax for each succeeding year would have been accruable in similar fashion.

generally have accrued franchise tax based on an "income year" until the first day of the following "taxable year". While the revenue ruling is based in part on our holdings in Central Inv. Corp. v. Commissioner, 9 T.C. 128 (1947), and Epoch Food Serv., Inc. v. Commissioner, 72 TO. 1051 (1979), those cases did not address the effect of section 23222(a) of the California code on the accruability of California franchise tax in a corporation's second taxable year where the first taxable year was less than 12 months.[11] The impact of section 23222(a) on the case before us is a "fact" determining whether the all events test has been met. Petitioner's initial misconstruction of the facts in reliance on respondent's revenue ruling should not be viewed as a method of accounting other than the accrual method. Applying petitioner's method of accounting to the correct facts is not a change in accounting method requiring respondent's approval. We hold that petitioner is entitled to accrue and deduct franchise tax in the amount of $932,979 for purposes of computing its Federal income tax for the taxable year ended December 31, 1988.

Decision will be entered under Rule 155.

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[11] We note that the facts described in Rev. Rul. 79-410, 1979-2 C.B. 213, 213-214, address the impact of California law prior to the 1972 amendment where a corporation's first year was "other than a short year". (Emphasis added.)

APPENDIX C
ORDER OF THE COURT OF APPEALS FOR THE NINTH CIRCUIT
DENYING PETITION FOR REHEARING
FILED MARCH 17, 1999

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

THE CHARLES SCHWAB CORPORATION AND INCLUDABLE SUBSIDIARIES, Petitioner-Appellant, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	No. 97-70917 Tax Ct. No. 1271-92 ORDER

Before: ALARCON, O'SCANNLAIN and FERNANDEZ, Circuit Judges

The panel has voted to deny the petition for rehearing. Judge O'Scannlain and Judge Fernandez have voted to deny the petition for rehearing en banc. Judge Alarcon recommends that the petition for rehearing en banc be denied.

The full court has been advised of the petition for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing and the petition for rehearing en banc are denied.

Supreme Court, U.S.
FILED
AUG 18 1999
OFFICE OF THE CLERK

(2)

No. 98-2010

In the Supreme Court of the United States

CHARLES SCHWAB CORPORATION AND INCLUDABLE SUBSIDIARIES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the commission income that petitioner earned by carrying out trades in stocks and other securities for its customers accrued on the date that the trades were executed or on the settlement date when petitioner delivered the securities or sale proceeds to its customers.

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In the Supreme Court of the United States

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COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The order of the court of appeals, which simply "adopt[s] the reasoning of the Tax Court" (161 F.3d 1231), is not reproduced in the appendix to the petition. The opinion of the Tax Court (Pet. App. 3a-31a) is reported at 107 T.C. 282.

JURISDICTION

The judgment of the court of appeals (Pet. App. 1a-2a) was entered on December 9, 1998. A petition for rehearing was denied on March 17, 1999 (Pet. App. 32a). The petition for a writ of certiorari was filed on June 15,

1999. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

REGULATIONS INVOLVED

1. As in effect during the years at issue, 26 C.F.R. 1.446-1(c) (1989) provided in relevant part:

§ 1.446-1. General rule for methods of accounting.

* * * * *

(c) *Permissible methods*—(1) In general. Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

* * * * *

(ii) *Accrual method.* Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. * * *

2. As in effect during the years at issue, 26 C.F.R. 1.451-1(a) (1989) provided as follows:

§ 1.451-1. General rule for taxable year of inclusion.

(a) *General rule.* Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

STATEMENT

1. Petitioner provides discount brokerage services through its membership in securities exchanges. As a discount broker, petitioner does not offer the services that a full-service brokerage firm provides—such as underwriting, market making and portfolio management. It also does not give investment advice and does not act as a principal in securities transactions (Pet. App. 7a-8a). When petitioner opens a customer account, the customer signs an agreement acknowledging that petitioner does not provide investment advice. The only service provided by petitioner under its customer agreements is the execution of trade orders (*id.* at 18a).

Each of petitioner's customers is required to provide credit information and to maintain an account with funds on deposit. If a customer fails to make payment on an order, petitioner may liquidate the account to collect amounts due on the trade, including the commission (Pet. App. 18a). The commission charged

by petitioner for executing trades for its customers is accounted for under the accrual method of accounting (*id.* at 6a).

2. In a typical transaction, a customer calls petitioner's telephone number and is connected with the first available representative (Pet. App. 8a-9a). After the customer gives the representative the details of the order, the representative transmits the order to the exchange for execution (*id.* at 9a). In a "market" order placed for immediate execution during the hours that the market is open, the representative ordinarily confirms that the trade has been executed while the customer is still on the telephone (*ibid.*). The market price in effect at the time of the trade determines the price paid or received by the customer; this price, in turn, determines the commission earned by petitioner (*ibid.*). The date on which the trade is executed is known as the "trade date" (*id.* at 8a).

Upon execution of a trade order, petitioner generates an automatic written confirmation slip, which is sent to the customer on the next business day. This written confirmation serves as a notification to the customer of the trade and as an invoice. It itemizes the total cost of the trade, including the commission due from the customer to petitioner, and it lists the total "amount due." The confirmation also encloses a remittance stub and a return envelope in which to transmit payment (Pet. App. 19a).

After the trade is executed, petitioner performs a series of administrative functions. These consist of: (i) recording, in which each transaction is assigned a number associated with the data needed to process the transaction; (ii) figuration, in which the net cost of the securities, commission, taxes, and other amounts associated with the trade are calculated (usually in batch

computer processing the night of the date the trade is executed); (iii) confirmation, in which petitioner mails a written description of the trade, specifying the commission, the settlement date, and other details, to the customer (usually on the first business day after the trade date); (iv) comparison, in which petitioner's records of the transaction are reconciled with those of the counter brokerage firm and with the customer's order, to resolve any discrepancies (beginning the first business day after the trade date and continuing up to settlement); and (v) booking, in which the transaction is entered on petitioner's records, including commissions due (Pet. App. 9a-11a).

On the "settlement date" of a purchase of securities, petitioner delivers the securities to the purchaser and collects the purchase price.[1] If the securities are held in "street name" (that is, in the broker's name), delivery of the securities can be made by a simple change in petitioner's records; if not, the stock certificates are endorsed by the seller and delivered to the buyer on the settlement date (Pet. App. 12a). During the period involved in this case, there was no federal rule specifying the time between the trade date and the settlement date. The exchanges, however, generally required transactions to be settled no later than the fifth business day after the trade date (*id.* at 13a).

Petitioner has a policy against allowing a customer to cancel an order placed in accordance with the customer's instructions (Pet. App. 14a, 19a). Petitioner has maintained in litigation with its customers that an executed order may not be canceled (*ibid.*; see *Yadav* v. *Charles Schwab & Co.*, Fed. Sec. L. Rep. (CCH)

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[1] On the settlement date of a sale of securities, petitioner delivers the proceeds, net of commissions, to the customer.

¶ 95,376 (S.D.N.Y. 1990), appeal reinstated, 935 F.2d 540 (2d Cir. 1991)). A customer's trade order may be canceled only if an entire transaction is canceled, such as when a planned initial public offering is canceled. In that case, the trades do not settle and petitioner collects no commission (Pet. App. 15a).

3. During its 1988 tax year, petitioner earned $3,357,576 in net commission income on transactions executed in that year that were settled in 1989 (Pet. App. 15a). Petitioner failed to include this income on its 1988 return. The Internal Revenue Service determined that this commission income should have been reported as accrued income in 1988. A notice of deficiency was issued based upon that determination.

Petitioner sought review of the deficiency determination in Tax Court. Following an extensive trial involving numerous documents and lengthy testimony, the Tax Court sustained the Commissioner's determination. Applying the "all events" test articulated by this Court in *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182, 184-185 (1934), and *Schlude* v. *Commissioner*, 372 U.S. 128, 133, 137 (1963), the Tax Court determined that (i) petitioner's right to receive the commission income became fixed on the date the securities trades were executed and (ii) this income therefore accrued to petitioner on that date, rather than on the subsequent date when the trades were settled (Pet. App. 17a, 23a). The court of appeals affirmed in a brief per curiam opinion that "adopt[s] the reasoning of the Tax Court" (161 F.3d 1231 (1998)).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. A corporation such as petitioner is required to use the accrual method of accounting in reporting and determining its federal income tax obligations. 26 U.S.C. 448(a), 451(a). For accrual basis taxpayers, an item of income accrues—and must therefore be reported—in the tax year when (i) all the events occur that fix the right to receive the income and (ii) the amount of the income can be determined with reasonable accuracy. 26 C.F.R. 1.446-1(c)(1)(ii), 1.451-1(a) (1989); *United States* v. *General Dynamics Corp.*, 481 U.S. 239, 242-243 (1987); *Commissioner* v. *Hansen*, 360 U.S. 446, 464 (1959); *Spring City Foundry* v. *Commissioner*, 292 U.S. 182, 184-185 (1934). Petitioner does not dispute that the amounts of the commissions involved in this case were reasonably determinable on the trade date and that the second prong of the accrual test was therefore met on that date. Petitioner disputes only the determination of the Tax Court, in which the court of appeals concurred, that the first prong of this established test was also met in 1988.

a. Under the accrual method, "it is the *right to receive* and not the *actual receipt*" of an item that determines the timing of its inclusion in income. *Schlude* v. *Commissioner*, 372 U.S. 128, 137 (1963) (quoting *Spring City Foundry* v. *Commissioner*, 292 U.S. at 184-185). Accord *Commissioner* v. *Hansen*, 360 U.S. at 464; *Resale Mobile Homes* v. *Commissioner*, 965 F.2d 818, 822 (10th Cir.), cert. denied, 506 U.S. 874 (1992).

Accrual occurs at the time that a liability to pay or a right to receive a certain amount is "firmly established." *United States* v. *General Dynamics Corp.*, 481 U.S. at 243. See also *Schlude* v. *Commissioner*, 372 U.S. at 137. The fact that taxpayers "cannot *presently* compel [a debtor] to pay to them the amounts [due]" is not controlling. *Commissioner* v. *Hansen*, 360 U.S. at 464. Such amounts accrue as income as soon as the taxpayers acquire "a *presently enforceable right to recover*" the amounts. *Ibid.*

For example, in *Commissioner* v. *Hansen*, automobile dealers argued that they were not required to accrue amounts in reserve accounts owed to them by finance companies because the dealers did not have the right to require present payment of those amounts. In rejecting this argument, the Court observed: "[I]t is a normal result of the accrual basis of accounting and reporting that taxes frequently must be paid on accrued funds before receipt of the cash with which to pay them." 360 U.S. at 466-467. Once an accrual-basis taxpayer has earned the right to payment for services rendered, it must report the income as accrued even if it must later carry out mathematical "calculations" or "ministerial acts" to complete its undertakings. *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290, 295-296 (1932); *Resale Mobile Homes* v. *Commissioner*, 965 F.2d at 823.

b. The courts below properly applied these established principles to the facts of this case. The courts correctly held that it is the execution of a trade order from a customer—by locating a seller or purchaser for a specific security on terms acceptable to the customer—that fixes petitioner's right to receive its commission on the trade. The sole service for which customers agree to pay a commission to petitioner is the execution of

securities trades. After petitioner executes the order according to the customer's instructions, the order cannot be canceled and the cost of the trade, including the commission, is promptly billed to the customer (Pet. App. 14a, 18a-19a). The administrative services that petitioner thereafter performs in delivering the securities and collecting its commission are ministerial in nature. Since petitioner's *right to receive* its commissions is fixed on the trade date, it is on the trade date that income accrues to petitioner. See, *e.g.*, *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. at 295 (income accrues regardless of necessity of carrying out a "mere administrative procedure to ascertain the amount to be paid"); *Resale Mobile Homes* v. *Commissioner*, 965 F.2d at 823 ("[a]n accrual basis taxpayer must report income in the year the right to such income accrues, despite the necessity for mathematical computations or ministerial acts"); *Dally* v. *Commissioner*, 227 F.2d 724, 726 (9th Cir. 1955), cert. denied, 351 U.S. 908 (1956) (contractor cannot postpone accrual of payments for units delivered in 1942 until 1943 on the basis that the units had not been certified for payment until the later year). The application of these well-established principles to the particular facts of this case does not warrant review by this Court.

2. Petitioner errs in contending (Pet. i, 3, 5-11) that the decision in this case conflicts with the decision of this Court in *United States* v. *General Dynamics Corp.*, 481 U.S. 239 (1987). The issue addressed in *General Dynamics* was whether a company that acted as a self-insurer for its employee medical expenses could accrue and deduct its liability to reimburse covered medical expenses when the employees had failed to file required claims for reimbursement by the close of the year. 481 U.S. at 244. The Court concluded that the last event

that fixed the company's liability to pay the medical claims was the submission of a proper claim by the employee, for the company had no obligation to reimburse the employee in the absence of the filing of the claim. *Ibid.* The Court observed that claim filing was "not a mere technicality" because employees might fail to file proper forms "through oversight, procrastination, confusion over the coverage provided, or fear of disclosure to the employer of the extent or nature of the services received." *Ibid.* In *General Dynamics*, the Court pointed out that, by contrast, the subsequent *processing* of the forms by the employer was merely a "ministerial" act that would not postpone accrual of the expenses on the company's tax return. 481 U.S. at 244 n.4.

The holding of the courts in the present case that petitioner must accrue commission income in the tax year in which the trades are executed is entirely consistent with the Court's application of the "all events" test under the different facts involved in *General Dynamics*. The execution of securities trades by petitioner is the event that fixes its right to commissions. The post-trade activities performed by petitioner are ministerial functions which, under *General Dynamics* and numerous other decisions, provide no basis to defer accrual of the commission income. See 481 U.S. at 244 n.4; *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. at 295; *Resale Mobile Homes* v. *Commissioner*, 965 F.2d at 823. Following completion of a trade, petitioner is required, of course, to deliver to its customer the securities purchased by the customer or the proceeds from securities sold by the customer. The record of this case, however, amply supports the conclusion of the courts below that these events are of a ministerial nature because they do no more than

"effectuate the mechanics of the transfer and are merely in confirmation of the trade executed" (Pet. App. 18a).[2]

This finding, in which both courts below concurred, does not warrant further review. "[T]his Court has frequently noted its reluctance to disturb findings of fact concurred in by the two lower courts." *Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982). See also *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

3. It is well established, for federal income tax purposes, that petitioner's customers must themselves recognize gain or loss from any sale of securities on the trade date. Rev. Rul. 93-84, 1993-2 C.B. 225; S. Rep. No. 313, 99th Cong., 2d Sess. 131 (1986); H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. Pt. 2, at 297 (1986); *Anderson* v. *Commissioner*, 527 F.2d 198, 199 (9th Cir. 1975).[3] Consistent with that general principle, the Commissioner of Internal Revenue has long taken the position that brokerage commissions from securities trades similarly accrue as of the trade date, not the settlement date. Rev. Rul. 74-372, 1974-2 C.B. 147. The

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[2] Petitioner argues (Pet. 11) that the decisions below contradict "plain common sense" because "[t]he 'essence' of a sale, from a customer's perspective, is the receipt in hand of the net cash proceeds" or, in the case of a purchase, "the delivery of the securities purchased." This argument, however, misdescribes the nature of the transaction. Petitioner executes securities sales and purchases solely as a broker or agent. It does not act as a principal (Pet. App. 7a-8a).

[3] Similarly, in insider-trading cases, courts have held that the trade date, rather than the settlement date, determines whether a purchase or sale of stock falls within the six-month short-swing profit period defined by 15 U.S.C. 78p(b). *Winston* v. *Federal Express Corp.*, 853 F.2d 455, 456 (6th Cir. 1988).

decisions below thus merely implement what has been the formal position of the Internal Revenue Service for the past twenty-five years. In this context, it is plainly unwarranted for petitioner to assert that the decision in this case will destabilize and "confuse the Nation's taxpayers" (Pet. 15) in determining the proper accrual of items of income and expenses.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 98-2010

IN THE
Supreme Court of the United States

THE CHARLES SCHWAB CORPORATION and INCLUDABLE SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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REPLY BRIEF FOR THE PETITIONERS

1. Respondent begins the substance of his argument by asserting that it is the "execution" of a trade order -- *i.e.*, the matching of a buyer with a seller or vice versa -- that fixes Petitioner's right to its commission. This is so, Respondent asserts, because "the sole service for which customers agree to pay a commission to petitioner is the execution of securities trades" (Resp. Br. 8). This assertion is flatly contradicted by the record. The standard customer contract between Petitioner and its customers states without qualification that the customer agrees to pay a commission only when a purchase or sale transaction is effected in the customer's brokerage account (Pet. Br 4).[1] Moreover, the confirmation/invoice Petitioner sends to its customer after a trade is executed but before settlement, states that payment is due on the *settlement* date. (Pet. Br. 4.) Thus, unless Petitioner settles the transaction -- which means effecting the actual exchange of money and securities, not merely the execution of a trade order -- it has no contractual right to be paid.[2]

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[1] We reproduce the contract's "Terms and Conditions" section in the Appendix because of Respondent's misconceptions about this critical point. *See* Reply App. 1-a, Part 1, par. 1, which states: "Schwab will open a Cash Account for you and will act as your broker in purchasing and selling securities on your instructions. ... You agree to pay Schwab's brokerage fees, as they exist from time to time, for securities *transactions* in your Brokerage Accounts" (emphasis supplied). Executing a trade order is merely the first step of a "transaction" in the customer's account that is completed when settlement occurs.

[2] Respondent evidences a continuing, fundamental lack of comprehension of the essence of Petitioner's contract with its customers (Resp. Br. 11 n.2). Customers hire Petitioner to secure for them the fruits of a completed transaction -- net cash proceeds if the transaction is a sale; securities if the transaction is a purchase. The accuracy of this description is clear from the terms of the contract and from plain common sense. If Petitioner ceased its activities after merely "executing" a trade order, Petitioner's customer would have no ability to settle the transaction on her own since (among other things) the buyer or seller is unknown to Petitioner's customer due to the very mechanics of the securities exchange system. Without Petitioner's post-execution activities, Petitioner would not have earned its commission but would have a very annoyed, empty-handed customer to deal with.

(footnote continued...)

2. Respondent contends that execution "fixes" Petitioner's right to the commission because once a customer's buy order or sell order has been executed, the customer loses the ability to cancel the order (Resp. Br. 5-6, 9). Respondent thus advances here the argument that the *taxpayer* made (and this Court rejected) in *United States v. General Dynamics*, 481 U.S. 239 (1987). In *General Dynamics*, the taxpayer maintained a medical expense reimbursement plan for its employees. The taxpayer argued that once an employee had incurred covered medical expenses, the taxpayer lost any ability to avoid liability for reimbursement by taking any unilateral action, and that there was only a remote possibility that the employee would fail to file a claim. The taxpayer argued that, as a result, it was entitled to accrue a deduction for its inevitable liability for those claims. This Court nonetheless held that the taxpayer's potential reimbursement obligation could not be accrued under the "all events" test. This Court agreed with Respondent's view, in that case, that an unconditional obligation to make a payment to an employee did not arise until that employee filed a claim for reimbursement. This Court noted that even though the taxpayer "could not avoid its obligation to pay for services after they were received by, for example, discharging the employee...[t]he filing of the claim is ... a true condition precedent to liability on the part of the taxpayer." 481 U.S. at 244 n.5.

Similar facts are present in this case. Upon execution of the customer's order, there is a contra-broker whose customer has

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Respondent contends that the foregoing "misdescribes the nature of the transaction" because Petitioner "executes securities sales and purchases solely as a broker or agent ... and not as a principal." *Id.* Respondent's statement is a baffling *non sequitur*. When Petitioner delivers the cash or securities into the customer's brokerage account at settlement, it is indeed acting as an agent and not as a principal for its customer; the nature of the transaction is nonetheless as described above. Petitioner acts as a principal only when it is trading for its own brokerage account and not for its customer accounts; even in that case, the essence of the transaction is the delivery of the cash or securities at settlement into Petitioner's brokerage account.

accepted the terms of the offer and agreed to be on the other side of the trade. Therefore, Petitioner's customer has lost the ability to avoid paying the commission by unilaterally reneging on the trade.[3] Like the employer-taxpayer in *General Dynamics*, who was obligated to pay the employee unless the employee failed to meet his contractual obligation to file the claim, Petitioner's customer must pay the brokerage commission unless Petitioner fails to meet its contractual obligation to effect the transaction. As in *General Dynamics*, the fact that only Petitioner's failure, for whatever reason, to complete the transaction can avoid that payment obligation serves to underscore the status of Petitioner's obligation as a true condition precedent. Unless and until the transaction is completed -- on the settlement date -- there is no unconditional right to the commission income.

3. Respondent contends that Petitioner's services in "delivering the securities and collecting its commission"[4] following execution of a trade order are "administrative" and

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[3] Respondent cites *Yadav v. Charles Schwab & Co., Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,376 (S.D.N.Y. July 18, 1990), *aff'd*, 948 F.2d 1277 (2d Cir. 1991) (Resp. Br. 5-6). That case is inapposite for many reasons. First, Petitioner was found entitled to its commission because it completed the stock purchase transaction, not merely because it executed the order. Further, in *Yadav*, both parties *agreed* that the customer's request to cancel was not effective if made after the order was executed. The issue was, therefore, merely one of credibility. The customer claimed that he had told Petitioner to cancel the order on October 19, 1987 (Black Monday), *before* the order had been executed. The New York Stock Exchange arbitration panel, however, believed Petitioner's statement that Yadav attempted to cancel the order only *after* it had been executed, in the hope of avoiding losses in a plummeting market.

[4] Contrary to Respondent's assertion, Petitioner does not contend that "collecting" the commission (Resp. Br. 9) is a precondition to its right to the commission. However, *sending* the customer a confirmation is required by the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq.* (The "Exchange Act"), and is such a precondition. Petitioner sends a confirmation the day after the trade date showing the amount of commission due (and other information) in order to comply with the anti-fraud provisions applicable to brokers and dealers. Rule 10b-10, 17 C.F.R. § 240.10b-10 (formerly Rule 15c1-4), requires the confirmation by the "completion of the transaction" -- which the SEC has ruled is settlement. Rule 15c1-1(b), 17 C.F.R. § 240.15c1-1(b).

"ministerial in nature" (Resp. Br. 4, 9). However, the courts below made no factual findings that justify that legal characterization of Petitioner's activities, and Respondent's legal arguments do not compel it. Any potential right to commission income that arises from the execution of the order is uncertain and contingent until the occurrence of two future events -- clearing[5] and settling[6] the transaction, which are both required by the U.S. Securities and Exchange Commission.[7] Those are not merely "administrative" or "ministerial" matters. They are substantive requirements of Petitioner's contract with its customers and of the federal securities laws. It is only after the completion of these additional steps that a customer has any liability to Petitioner, and until that time, Petitioner's right to its commissioner is not "firmly established" within the meaning of *General Dynamics*, 481 U.S. at 243.

4. The apparent crux of Respondent's argument is his discussion of case law regarding "ministerial" acts, since in this discussion, Respondent in effect urges an expansion of the scope

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[5] The term "clearance" includes the comparison of data regarding the terms of settlement of securities transactions and the allocation of securities settlement responsibilities. After trade comparison, Petitioner's, as well as most other brokers', trades clear through a continuous net settlement system ("CNS") operated by a clearing corporation registered with the Commission under Exchange Act § 17A, 15 U.S.C. § 78q-1. Under CNS, the clearing corporation nets each clearing member's purchases and sales to arrive at a daily net receive or deliver obligation for each security and a daily net settlement payment obligation. S.E.C. Release No. 34-33023, 55 S.E.C. Docket 332 (Oct. 6, 1993), at n.5; *see* Exchange Act, § 3(a)(23)(A), 15 U.S.C. § 78c(a)(23)(A).1.

[6] The term "settlement" includes the delivery of securities in exchange for funds, pursuant to the terms of the originating order, and the custody of securities. *Id.*

[7] Moreover, Congress and the S.E.C. have declared that clearance and settlement are integral aspects of effecting a securities transaction and are not "clerical" or "ministerial" functions, and that a broker is providing brokerage services when it clears and settles a transaction. Exchange Act § 17A, 15 U.S.C. § 78q-1; S.E.C. Release No. 34-32018, 58 Fed. Reg. 16151, 16153 & n.25 (1993) (promulgating Rule 15b-7, 17 C.F.R. § 240.15b7-1); *see generally* S.E.C. Release No. 34-33023, 55 S.E.C. Docket 332 (Oct. 6, 1993).

of the term "ministerial acts" as laid down by this Court in *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290, 295-96 (1932), and as adhered to in *General Dynamics*. In fact, none of the cases cited by Respondent or in the opinion below supports the proposition that a party's performance of its contractual duties can be dissected into "essential" acts and lesser acts that are "ministerial" "conditions subsequent." Instead, the cited cases hold that the term "ministerial acts" only encompasses the computation or collection of sums already earned following completion of a party's contractual performance. *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290 (1932) (performance completed; mathematical computations were ministerial); *Dally v. Commissioner*, 227 F.2d 724 (9th Cir. 1955) (performance completed; billing and collection were ministerial); *Resale Mobile Homes, Inc. v. Commissioner*, 965 F.2d 818, 823 (10th Cir. 1992), *cert. den.* 506 U.S. 874 (1992) (performance completed; computations were ministerial, contingencies as to collectibility were conditions subsequent); *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214, 217-18 (2d Cir. 1952) (performance of services completed; computations were ministerial, contingencies as to collectibility were conditions subsequent); *Georgia School-Book Depository, Inc. v. Commissioner*, 1 T.C. 463, 468-470 (1943) (performance completed; contingencies as to collectibility were conditions subsequent).

Respondent further contends that the filing of the claim forms by employees was not ministerial because of the possibility that claim forms would not be filed, and that "by contrast," the *processing* of the claim forms was merely "ministerial" (Resp. Br. 10). Petitioner respectfully submits that the reason that the filing of claim forms was not a "mere technicality" (*General Dynamics*, 481 U.S. at 244) was instead that, under the terms of the contract between General Dynamics and its employees, General Dynamics was "liable to pay for covered medical services *only* if properly documented claims forms were filed." *Id.*; emphasis in original. This Court thus concluded that, "as a matter of law, the filing of a claim was necessary to create

liability." In the instant case, the last act necessary to secure to Petitioner the contractual right to payment was settlement of the transaction. As was true of the claim filings in *General Dynamics*, settlement of transactions in the instant case was, while not a certainty, statistically highly probable.

Therefore, contrary to Respondent's assertion, *General Dynamics* rules the outcome of this case, and the decision below is inconsistent.

5. Whether the inclusion of an item in income is required because the "all events" test has been satisfied is a question of law, *Challenge Publications, Inc. v. Commissioner*, 845 F.2d 1541, 1543 (9th Cir. 1988); *Resale Mobile Homes, Inc. v. Commissioner*, 965 F.2d at 821. The concern this Court may have over disturbing a lower court's findings of fact is not present in this case. Indeed, in *General Dynamics* itself, both lower courts found that filing the claim forms in question was not necessary to accrual -- findings reviewed and reversed by this Court. Therefore, this Court should not hesitate to reject, as Petitioner urges it to do, the lower courts' mistaken characterization of substantive contractual duties as "ministerial acts."

6. Respondent asserts that when he issued Rev. Rul. 74-372, 1974-2 C.B. 147, he took the "position" that brokers must accrue commissions on trade dates "consistent with th[e] general principle" that "petitioner's customers must themselves recognize gain or loss from any sale of securities on the trade date" (Resp. Br. 11).[8] Respondent is engaging in wishful revisionist history.

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[8] Respondent asserts the irrelevant in stating that "in insider trading cases, courts have held that the trade date, rather than settlement date, determines" short-swing profits liability under Section 16(b) of the Exchange Act, 15 U.S.C. § 78b(b). Courts have held in that manner because the provisions of the Exchange Act require them to treat the trade date as determinative. Exchange Act §§ 3(a)(13) and (14), 15 U.S.C. §§ 78c(a)(13) and (a)(14), define, respectively, the terms "buy" and "purchase" as each including any *contract* to buy, purchase, or otherwise acquire securities, and the terms "sale" and "sell" as each including any *contract* to sell or otherwise dispose of securities. It is the trader's *agreement* to do the transaction, which occurs on the trade date, that fixes Section 16(b) liability. The contract date, rather

(footnote continued...)

In 1974, and up until 1986, as Respondent's own published revenue rulings recognize, *see, e...* Rev. Rul. 78-270, 1978-2 C.B. 215, the "general principle" was that customers recognized gains *on the settlement date*, when they received the proceeds of sale.[9]

Rev. Rul. 74-372 was instead a reflection of a litigation goal formulated in Respondent's General Counsel Memorandum ("G.C.M.") 34853 (April 21, 1972).[10] In G.C.M. 34853, Respondent reviewed the Tax Court's decision in *Georgia School-Book Depository v. Commissioner*, *supra*, a case in which a school-book broker was required to accrue commission income upon delivery of books to the state instead of upon receipt of payment from the state. *Georgia School-Book Depository* simply states the rule that billing and collection are not part of the activities that earn the right to income. However, in G.C.M. 34853, Respondent expressed the "belief" that *Georgia School-Book Depository* stands for a much broader principle, namely that income can accrue upon performance of

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than the settlement date, is determinative because the issue is whether the trader was a statutory insider presumed to have access to inside information on the day he became obligated to buy or sell the stock. If the settlement date were used, insiders could buy or sell on the trade date, take some action before the settlement date to change their insider status (*e.g.*, more-than-10% shareholders could dump enough stock to lose their statutory insider status), and avoid Section 16(b) liability.

[9] Respondent's contention that the income tax consequences to customers have any relevance to this case is unfounded (Resp. Br. 11). *Anderson v. Commissioner*, 527 F.2d 198 (9th Cir. 1975), has nothing to do with the *timing* of gain recognition from securities sales, but is concerned only with determining whether gains were long- or short-term. When Respondent issued Rev. Rul. 93-84, 1993-2 C.B. 225, it was merely a reflection of a statutory change to the installment sale rules made in the Tax Reform Act of 1986, P.L. 99-514. As a policy matter, installment method reporting of gain from the sale of publicly traded securities had been ended because it was thought that such securities were sufficiently liquid to make availability of the installment method unnecessary. *See* S. Rep. No. 99-313, 99th Cong., 2d Sess. 124; 1986-3 (Vol. 3) C.B. 131.

[10] G.C.M.s are issued by respondent's Chief Counsel, and reflect the highest level of Respondent's litigation policy.

"primary" services even though "other incidental services" have not yet been performed. In furtherance of this "belief," the G.C.M. directs the issuance of Rev. Rul. 74-372. Rev. Rul. 74-372, therefore, does not reflect any substantive study of broker-dealers but is merely a litigation wish using broker-dealers as a convenient vehicle. In addition, it is clearly inconsistent with the holding of this Court in *General Dynamics*. Consequently, it is entitled to no deference by this Court.

7. Respondent asserts that "[i]n this context," it is "plainly unwarranted" to think that the lower courts' decision in this case will "destabilize and 'confuse the Nation's taxpayers'" in determining when items accrue for federal income tax purposes. The "context" to which Respondent refers, however, is only that of brokers accruing commissions. The danger -- and a substantial reason that Petitioner believes that this case merits this Court's review -- is that Respondent will seek to apply that decision in other "contexts."[11]

In our Petition, we expressed the concern that whether an act or event is considered "ministerial" is an essentially subjective standard that inherently cannot be consistently applied and, if the decision below is allowed to stand, will produce different results for similar taxpayers in similar circumstances. It is telling that Respondent did not respond in his Opposition Brief to those concerns, particularly since they are dramatically illustrated by Respondent's own inconsistency in determining whether given acts are or are not "ministerial" -- a determination that is at the very core of the test that Respondent is seeking to uphold.

In Technical Advice Memorandum ("TAM") 9409007 (Nov. 16, 1993), Respondent himself, in technical advice to his field

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[11] In Field Service Advice 199904031 (Nov. 16, 1998), even before the Ninth Circuit had spoken in the instant case, Respondent applied the Tax Court decision below to signing bonuses of a taxpayer in an operating business:

> Although [the taxpayer's] failure to fulfill its obligations might ultimately divest [it] of its right to the bonus, the conditions imposed in the contract are insufficient in our view to prevent [the taxpayer] from acquiring a right to the bonus in Year 1 and do not preclude accrual of the income. *See Schwab*, 107 T.C. at 293-294.

agents,[12] characterized the filing of the employee claims in *General Dynamics* as "ministerial." but, nonetheless, a legal condition precedent to accrual:

> The Court [in *General Dynamics*] stated that deduction of the reserve accounts failed the all events test because the last event necessary to fix the taxpayer's liability was not the receipt of medical care by covered employees, but rather, the filing of properly documented claims forms. Such a filing, *although ministerial in nature*, was not a mere technicality but rather a condition precedent of liability. [Emphasis added.]

Thus, in advising his field agents, Respondent characterizes the filing of claim forms in *General Dynamics* as "ministerial." In contrast, in its Opposition Brief, Respondent asserts to this Court that the same filings of the same forms to obtain reimbursement from the same employer (General Dynamics) were *not* "ministerial." Petitioner submits that the need for this Court's review of this case is amply demonstrated by Respondent's changeable attitude on the issue of what "ministerial" signifies even in a single context. It is a virtual certainty that, if the decision below is allowed to stand, minor variations in facts will lead to inconsistent differences in characterization and unpredictability in application of the federal income tax laws which the courts will be time and again asked to resolve.

8. In Respondent's petition for certiorari in *General Dynamics*, Respondent stated (at pages 7-8):

> This case presents an important question of federal tax law. The decision below is squarely at odds with fundamental principles that this Court has enunciated to govern accrual of [items] under the "all events" test of tax accounting, and

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[12] Because TAMs arise in the context of actual audit controversies, they are widely relied upon by Respondent's agents -- and by taxpayers -- as authoritative expressions of Respondent's administrative positions. *Cf. Rowan Cos. V. United States*, 452 U.S. 247, 261 n.17 (1981).

it conflicts with the decisions of other courts of appeals that have applied those principles.

Respondent argued that "[t]he decision below produces an irrational result" and that the "impact" of the lower court decision, having been "rendered by a court of nationwide jurisdiction, is substantial." Respondent concluded that "[r]eview by this Court is therefore appropriate."

The instant case is essentially *General Dynamics* applied to income items instead of deduction items, and we respectfully submit that it is as significant to the Nation's taxpayers. Because it affects basic elements of the "all events" test, the lower courts' decision affects every accrual-method taxpayer in the nation, as did *General Dynamics*. The decision below is, as we believe we have demonstrated, squarely at odd with the principles that this Court enunciated in *General Dynamics* and *Continental Tie & Lumber Co.* and therefore conflicts with every other decision that applies those principles. The Ninth Circuit adopted the decision of the Tax Court -- a court of nationwide jurisdiction -- and the resulting impact if that decision is allowed to stand cannot be other than substantial. In consequence, we believe that review of that decision by this Court is necessary.

CONCLUSION

For the foregoing reasons and those stated in the Petition, this Court should grant the Petition for a Writ of Certiorari.

Respectfully submitted,

Dated: August 1999

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APPENDIX A

SCHWAB BROKERAGE ACCOUNT TERMS AND CONDITIONS

The Cash Account is the basic brokerage account offered by Schwab. In addition to the Cash Account, you may elect to maintain with Schwab a Margin and Short Account and/or an Options Account. These accounts, along with the Cash Account, are referred to in these Terms and Conditions as the "*Brokerage Accounts.*"

PART I: BROKERAGE ACCOUNTS

1. *Purchase of Sale of Securities*. Schwab will open a Cash account for you and will act as your broker in purchasing and selling securities on your instructions. If you apply and Schwab approves your application, Schwab will also open a Margin and Short Account and/or an Option Account. You agree to pay Schwab's brokerage fees, as they exist from time to time, for securities transactions in your Brokerage Accounts.

2. *Services Provided*. Schwab executes orders for securities only and does not give investment advice. Schwab will not advice you on any matter pertaining to the suitability of any order for you or offer any opinion concerning the nature, potential value, or suitability of any particular security.

3. *Applicable Rules and Regulations*. All transactions shall be subject to the rules, regulations, customs and usages of the exchange, market, or clearing house where executed, and to all applicable federal and state laws, rules, and regulations.

4. *Deposit of Equity*. Schwab may require full payment or an acceptable equity deposit prior to the acceptance of any order.

5. *Security for Indebtedness*. As security for the discharge of all your indebtedness and other obligations to Schwab under these Terms and Conditions, you grant to Schwab a security interest in all securities or other property now or hereafter held, carried, or maintained for any purpose in or for any of your present or future Brokerage Accounts, whether individual or jointly held with others. Whenever Schwab, in the reasonable exercise of its sole discretion, deems it necessary for its

protection, or to satisfy a margin deficiency, Schwab may sell, assign, and deliver all or any part of the securities or other property, or close any or all transactions in your Brokerage Accounts. Schwab shall also have the right to transfer securities and other property in any of your Brokerage Accounts from or to any other of your Brokerage Accounts, if in Schwab's opinion there is inadequate security for your obligations or if necessary to satisfy a margin deficiency.

6. *Payment of Indebtedness Upon Demand.* You will at all times be liable to make payment upon demand of any debit balance or other obligation owing in any of your Brokerage Accounts.

7. *Customer Remittances.* You may make remittances for credit to your Brokerage Accounts at any Schwab office. If a check or other item you remit to Schwab is returned unpaid, Schwab will deduct a $15 fee from your Brokerage Accounts.

8. *Customer Duties on Sale of Control or Restricted Securities.* Prior to giving Schwab a sell order in connection with any securities subject to Rules 144 or 145(d) under the Securities Act of 1933, you agree to advice Schwab of the status of such securities and to furnish or cause to be furnished promptly such information and documents (including opinions of your counsel) that Schwab may require in order to comply with its regulatory duties.

9. *Change in Account Information.* You agree to notify Schwab in writing if there is any material change in the facts set forth in the Account Information section of your New Account Application and Agreement. In particular, you agree to inform Schwab in writing if you become a director, 10% shareholder, or policy-making officer of a publicly-traded company, or if you become affiliated with or employed by any securities firm, bank, trust, or insurance company.

10. *Multiple Account Holders.* If there is more than one account holder, each account holder shall have authority, acting alone, to take action with respect to such account, and Schwab may deliver securities and other property in connection with account transaction to any account holder without notice to the other.

11. *Definitions*. For purpose of this Agreement, "securities" and "other property" shall include money and securities of any kind and nature and all contracts and options relating there. To "*close any or all transactions*" with respect to any account shall mean to cancel any or all open orders, to sell any or all outstanding long contracts or securities, and to buy any or all securities and other property that may be short in such account. Such transactions may be made without notice or demand, and may be made on whatever exchange or market and in whatever manner (including public auction or private sale) Schwab deems most expeditious, in the exercise of its business judgment.